

STATE INVESTMENT COMMISSION
MINUTES

December 11, 2000

The State Investment Commission meeting was called to order by Jonathan Miller, State Treasurer on December 11, 2000 at 2:30 p.m. in Room 264 of the Capitol Annex. Other members present were Orson Oliver, Bank of Louisville; Thomas Brumley, Area Bancshares; and Kevin Flanery, proxy for John P. McCarty, Secretary, Finance and Administration Cabinet.

Treasurer Miller confirmed that a quorum was present and the press had been notified of the meeting. On a motion by Mr. Oliver with a second by Kevin Flanery, the minutes of the September 27, 2000 meeting were **APPROVED**.

Gordon L. Mullis, Executive Director, Office of Financial Management ("OFM"), provided a brief economic update. Mr. Mullis indicated that the Federal Reserve Board ("Fed") is scheduled to meet on December 19, January 31 and March 20. Based on information that he has read, Mr. Mullis believes that on December 19 the Fed will continue to take a neutral stance even though Mr. Greenspan has indicated his concern for the country's economic condition. He continued that the economy continues to weaken and that consumer confidence is lower than in the previous three years. Job growth is slowing, however, unemployment has risen to four percent. The GDP in the fourth quarter of 2000 and the first quarter of 2001 is estimated to grow at about 3 percent which is much slower than in past quarters. The price index will be released on Thursday and is expected to show a minus one-tenth of a percent decrease excluding food and energy costs. Retail sales is expected to show a decline of minus four-tenths of a percent. Consumer prices are expected to reflect a two-tenths of a percent growth but capacity utilization is down which results in fewer hours worked and a weakening of wages. The decline in wages creates concern about the consumer's willingness to buy. Decline in the purchase price may offset this, however, which will allow the economy to have a soft landing.

Mr. Mullis continued that on the state level, income growth is about three and one-half percent. Growth of five and one-half percent to six percent is needed over the remaining few months of this fiscal year to reach the target. Notable areas of concern on the state level are sales and use tax and individual income tax returns. Corporate and property taxes are above the target level year-to-date. The cost of home ownership is beginning to decrease and may soften the decline as consumers are able to purchase homes.

Chairman Miller asked about the Commonwealth not meeting its target for the remaining fiscal year. Mr. Mullis explained that receipts have not met the forecast at this time, but it is not expected to become a problem. Corporate and income tax returns are expected to yield an increase in receipts in January. Chairman Miller asked if this would impact the Commonwealth's investments and Mr. Mullis indicated that cash flows appear to be above average.

Dwight Price, portfolio manager, indicated that cash flows historically are negative from July to December and positive from January to June.

Mr. Price presented the portfolio update to the Commission. Mr. Price indicated that month-end summary sheets have been included for each portfolio. The sheets show the securities held in each pool. The long-term pool is shorter than it should be and has been extended to November 30. Modified duration on this pool should be 2.8 years but the pool presently has a modified duration of 1.98 years. Mr. Price stated that the pools are run shorter which takes some of the volatility out of the market. He indicated that when prices decrease the portfolio performs better and when the prices increase the portfolio does not perform as well as the index. Modified duration for the bond proceeds pool usually runs at 1.35 and is currently performing at 1.31. Modified duration for the intermediate pool should be 1.40 and is currently at 1.21.

Mr. Price indicated that current indices have been in use for the past five years and suggested that a review of the indices may be appropriate. Staff currently uses the Merrill Lynch indices because of the ease with which they can be accessed from the Internet. Lehman has a better selection and the indices are better known. However, the indices cannot be accessed readily and staff does not maintain a relationship with Lehman that would allow for accessing the indices without a fee.

Ron Ryan of the investment staff prepared a report that charts the performance of four securities and their total rate of return. The report shows the capability that staff currently has to track securities on a day-to-day basis which eliminates the need to rely on brokers for this information.

Mr. Price indicated to the Commission that the last two sheets represent the performance of the securities lending contract with Deutsch Bank. The first chart reflects the amount of collateral the Commonwealth has sent to the bank and the second chart reflects the amount earned year-to-date on the securities lending program which is \$680,276.

Mr. Price informed the Commission that the securities lending request for proposal is scheduled to be mailed within the next few days. Responses will be due the first week of January. Staff will review proposals and award the contract by February 1. Mr. Mullis added that by policy this is an annual process. Mr. Price indicated that staff has the discretion to renew the contract at the same rates for a second year but has not done so. Mr. Flanery asked why staff had never chosen the option to renew a securities lending contract. Mr. Price indicated that Lehman held the contract for several years, but their credit rating went down which made them ineligible to bid on the contract. Goldmans Sachs was awarded the contract and held the contract for three years until it was awarded to Deutsch Bank. He indicated that it was cumbersome to move the securities from firm to firm.

Chairman Miller asked if there was further business to come before the Commission. Mr. Mullis indicated that consideration was being given to scheduling the quarterly meetings in advance to

Allow members to plan for future meetings. Mr. Mullis also introduced the newest member of the investment staff, Ms. Kim Bechtel.

With no further business before the Commission, the meeting was adjourned.